

**The Internal Revenue Service Needs  
to Improve Treatment of Taxpayers  
During Office Audits**

**April 1999**

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INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

April 29, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Lawrence W. Rogers /s/Lawrence W. Rogers  
Acting Treasury Inspector General for Tax Administration

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to  
Improve Treatment of Taxpayers During Office Audits

This report presents the results of our review of the Internal Revenue Service's (IRS) treatment of taxpayers during office audits. We attempted to identify instances where taxpayers were, or could perceive they were, harmed when an IRS employee (1) violated a law or regulation, or (2) did not follow IRS procedures that govern its interactions with taxpayers.

In summary, the IRS risks losing the public's confidence in its ability to protect the privacy and security of taxpayers' personal and financial information in the examination process. Weaknesses in controls over district-based systems used to identify returns for examination increase the risk that IRS employees could selectively target individuals for audit.

Also, inappropriate practices could contribute to taxpayers' perceptions that they are not treated fairly by the IRS. We found instances where audit initiation letters contained unreasonable and intrusive requests for information. In other instances, form letters were altered by local offices and conflicted with IRS procedures and publications. Your response to the findings has been incorporated into the report where appropriate. In addition, the complete text of your response is included as an appendix to this report. Copies of this report are also being sent to IRS managers who are affected by the report recommendations.

Please call me at (202) 622-6500 if you have any questions, or your staff may contact Maurice S. Moody, Acting Assistant Inspector General for Audit at (202) 622-8500.

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## **Executive Summary**

A previous audit report titled, *Examination Division's Use of Performance Measures and Statistics*, dated July 7, 1998, identified concerns that led us to look at whether Examination Division's emphasis on enforcement results caused taxpayers to be treated improperly. Our review focused on the individual tax returns selected for office audit through means other than the Discriminant Index Function (DIF), primarily through the Midwest Automated Compliance System (MACS).

In the last several years, the Internal Revenue Service (IRS) has migrated away from the traditional DIF system for selecting individual returns for audit. In 1997, more than half of the audited individual returns selected came from non-DIF sources. This migration away from the DIF system can increase IRS' risk that tax return information could be misused. To mitigate the risk, the system of controls must keep pace with the new and innovative ways of doing business, such as using MACS to identify and select returns for audit.

## **Results**

Given the extent of control breakdowns identified during this audit, we cannot give assurance that IRS employees selected returns for examination fairly or that they protected taxpayers' personal and financial data from unauthorized and improper disclosure. We also noted inappropriate actions taken by examiners and managers during the initiation and closing of audits that may have led to improper taxpayer treatment. In some instances, examiners may have violated laws or regulations. In other instances, IRS procedures were not followed.

### **Weaknesses in the MACS Control Environment Unnecessarily Exposed Taxpayer Return Data to Browsing and Increased the Risk That Employees Could Selectively Target Individuals for Audit**

Traditionally, DIF has been the primary workload identification system used to select individual tax returns for office audits. DIF scores each return for potential errors by means of a mathematical formula. The higher the score, the greater the probability for error. When the computer selects a return because of a high DIF score, an employee, generally in one of IRS' Service Centers, screens the return for some obvious explanation or innocent error. If none is found, the questionable return is usually forwarded to the district for audit consideration. This process provides IRS with controls to (1) identify and select returns for audit and (2) separate the duties among employees identifying, selecting and auditing tax returns.

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Comparatively, MACS gives IRS employees a new and innovative way of identifying and selecting returns for audit. MACS provides IRS employees in district offices the ability to use locally-derived, and possibly subjective, criteria to both identify and select returns for audit from the millions of returns filed within the district's geographical boundaries.

IRS reports that MACS, unlike most other IRS computer systems, has controlled access protection to prevent and detect unauthorized access and misuse of taxpayer data. Officials in IRS' National Office developed comprehensive guidelines that outline additional procedures and controls to aid in protecting the security and privacy of taxpayer information on MACS. However, our tests and on-site visits to 14 district office MACS sites found a combination of factors that seriously undermined the entire MACS control environment. For instance:

- Over a two-month period, IRS employees in 14 districts accessed over 3,600 accounts on MACS that could not be traced to source documents that adequately explained the business purpose for the accesses. Vague MACS research requests, such as "identify taxpayers in specific market segments that will produce productive examinations," were used as control documents to support hundreds of account accesses (5 of 14 districts). Public Law, Treasury Directives, and the Internal Revenue Manual (IRM) prohibit IRS employees from obtaining access to taxpayer accounts without a valid business purpose. We are coordinating with our Unauthorized Access (UNAX) Program to further investigate these potential violations.
- Inadequate separation of duties existed among IRS employees responsible for identifying, selecting, and auditing tax returns (7 of 14 districts).
- MACS data discs containing return information were not adequately secured (4 of 14 districts).
- Controls were not established over MACS returns while they were screened for audit potential (12 of 14 districts).
- Audit trail files designed to detect an unauthorized access once it occurs were not reviewed, backed-up or maintained (13 of 14 districts).

### **Actions Taken by Examiners and Managers During the Initiation and Closing of Non-DIF Audits Led to Improper Taxpayer Treatment**

Although IRS has established procedures to protect taxpayers during audits, we found examples of what we consider to be improper taxpayer treatment during the initiation and closing of office audits. For example:

- We found no evidence in 803 of 1,806 sample cases reviewed that IRS employees provided taxpayers with a Publication 1 (Your Rights as a Taxpayer) and/or Notice

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609 (Privacy Act Notice) at the initiation of the audit, both of which are statutory requirements.

- IRS employees used discretionary enforcement powers in a way that appeared to create an unnecessary hardship for taxpayers. In 2 districts, 3,500 audits of low-income taxpayers claiming an Earned Income Tax Credit were started by sending a 6-page questionnaire requesting more than 80 items of information. The items requested included amounts spent on food, clothing, gifts, and cosmetics. Much of the information requested was intrusive and had little, if any, relevance to the issues being questioned.
- IRS employees in 15 districts improperly closed 211 returns as “surveys” (non-examined disposals) instead of closing them as being “examined without a change” or “with an additional assessment.” This practice reduced the reliability of program statistics and could lead to inadvertently violating the prohibition against repetitive audits under Internal Revenue Code §7605 if the same tax period were subsequently examined.

### **Summary of Recommendations**

The risk of selectively targeting taxpayers for examination and exposing the personal and financial data of millions of taxpayers to browsing and improper disclosure could be easier managed by centralizing the MACS sites. A better separation of duties could be achieved between the IRS employees responsible for identifying potential MACS returns for audit and the employees responsible for conducting the examination by locating MACS in offices other than those that will be working the audits.

IRS management also needs to strengthen specific IRS controls and procedures for initiating and closing audits. These include (1) making sure examiners and managers are knowledgeable of procedures designed to protect taxpayers during audits and (2) expanding the quality assurance controls to address taxpayer rights.

Due to the significant risks inherent in the selection, initiation, and closing of examinations, and the current state of the controls designed to mitigate those risks, these areas should be declared material weaknesses under the Federal Manager’s Financial Integrity Act (FMFIA).

Management's Response: *The Commissioner of the Internal Revenue Service provided comments on a draft of this report in a February 12, 1999, letter.*

*With the exception of centralizing MACS sites, the Commissioner agreed to take corrective actions that are consistent with our recommendations. Instead of centralizing MACS sites, he believes that the management of MACS should be centralized as a short-*

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*term solution to the issue. Our subsequent discussions with IRS officials indicate they are considering centralizing management oversight of MACS under a National Office analyst. IRS officials envision the analyst would be responsible for reviewing and approving MACS research requests. We still believe MACS sites need to be centralized, but see this interim solution as a step that would provide for a better separation of duties and enable IRS to easily identify misuses of MACS after they occur.*

*The Commissioner's comments on findings can be found at the end of our recommendations. Appendix IV contains IRS management's complete response.*

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## Objective and Scope

*Our review included an evaluation of controls over access to taxpayer information on MACS and samples of open and closed cases.*

Our primary objective was to assess the effectiveness of controls that protect taxpayers' rights during office audits. We attempted to identify instances where taxpayers were, or could perceive that they were, harmed when an Internal Revenue Service (IRS) employee (1) violated a law or regulation, or (2) did not follow IRS procedures governing interactions with taxpayers. A brief description of the tests we performed included:

- Evaluating controls over access to taxpayer information on the Midwest Automated Compliance System (MACS) to determine if taxpayer data were safeguarded against improper access or misuse during the audit identification and selection processes.
- Reviewing samples of closed and open cases to determine if taxpayers were treated properly during the initiation and closing of non-Discriminant Index Function (DIF) audits. In instances where it appeared actions were inappropriate, we evaluated the impact of those actions on program statistics.

We conducted fieldwork in 27 of the 33 IRS district offices from April 1998 through August 1998. Our review was conducted in accordance with generally accepted government auditing standards.

Appendix I contains the detailed objectives, scope, and methodology of our review. A listing of major contributors to this report is shown in Appendix II.

## Background

Traditionally, the DIF has been the primary workload identification system that IRS uses to select individual returns for audit. The DIF system rates each return filed for potential errors by means of a mathematical formula.



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*Unlike MACS, the DIF system provides a way of identifying and selecting individuals for audit.*

*MACS gives districts an ability not previously available because it allows immediate and easy access to their entire filing population.*

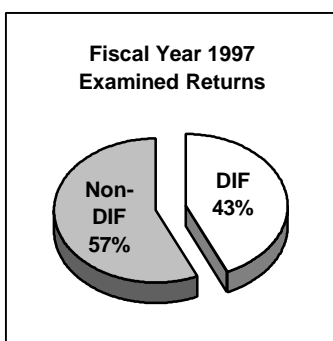


Figure 1

Returns with the highest DIF scores are generally screened by an employee at an IRS Service Center for some obvious explanation or innocent error. If none is found, the return is usually forwarded to the Examination Division for audit consideration. This process provides IRS with controls to (1) identify and select returns for audit and (2) separate the duties between employees selecting potential returns for audit and the employees auditing the returns.

Comparatively, MACS gives IRS employees in district offices a new and innovative way of identifying and selecting returns for audit. MACS allows immediate and easy access to computerized tax return information for a district's entire filing population. In other words, MACS gives IRS employees in district offices the ability to use locally-derived, and possibly subjective, criteria to identify, select, and audit returns from the millions filed within the district's geographical boundaries.

The General Accounting Office reported that in 1992, over 55 percent of the audited returns of individuals were selected using the DIF score. Figure 1 shows that in 1997, IRS had migrated away from DIF by selecting 57 percent of the audited individual returns from non-DIF sources such as MACS. As a result, unless the controls keep pace with new and innovative ways of identifying and selecting returns for audit, there is a greater risk for employees to abuse taxpayers' rights and privacy.

## Results

Given the extent of control breakdowns identified during this audit, we cannot give assurance that IRS employees selected returns for examination fairly, or that they protected taxpayers' personal and financial data from unauthorized and improper disclosure. We also noted inappropriate actions taken by examiners and managers during the initiation and closing of audits that may have led to improper taxpayer treatment. In some instances,

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examiners may have violated laws or regulations. In other instances, IRS procedures were not followed.

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### Weaknesses in the MACS Control Environment Unnecessarily Exposed Taxpayer Return Data to Browsing and Increased the Risk That Employees Could Selectively Target Individuals for Audit

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*IRS reports that, among its features, MACS has controlled access protection.*

IRS reports that MACS has controlled access protection to prevent and detect unauthorized accesses and misuse of taxpayer data. Officials in IRS' National Office developed comprehensive guidelines that outline additional procedures and controls to aid in protecting the security and privacy of taxpayer information located in the 44 MACS sites across the nation. However, weaknesses in how those procedures and controls were implemented seriously undermined the MACS control environment.

We were unable to determine if taxpayers had been selectively targeted for audit, due to weak controls in the MACS environment. However, we are coordinating with officials in our Unauthorized Access (UNAX) Program to identify instances of browsing as outlined in 18 USC §1030. In all, we visited 14 district office MACS sites and found the following control breakdowns:

*Accesses to over 3,600 taxpayer accounts made over a two-month period could not be verified even with assistance from IRS officials.*

*Unexplained accesses to taxpayer accounts (14 of 14 districts).* Unless there is sufficient information to justify accesses to taxpayer accounts, IRS is vulnerable to allegations that it targeted taxpayers for audit and that employees browsed taxpayers' accounts. We were not able to trace over 3,600 accesses made to taxpayer accounts over a two-month period to a MACS research request, Audit Information Management System (AIMS) listing, or other specific documentation such as MACS queries/filter lists.

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*Vague requests were used as supporting documentation to access hundreds of accounts.*

*Control documents severely limited the capability to prevent and detect unauthorized accesses (5 of 14 districts). Unless control documents are prepared uniformly and contain sufficient information to justify accesses to taxpayer accounts, it is nearly impossible to assure stakeholders that there has not been browsing, disclosure, or that an individual has not been selectively targeted for audit. We found instances where vague requests such as “identify taxpayers in specific market segments that will produce productive examinations” were used as control documents to support hundreds of account accesses.*

*Inadequate separation of duties existed between examiners who identified returns with potential tax changes for their group and examiners who conducted the audit (7 of 14 districts). Unless there is a separation of duties in these areas – a key control in the DIF system – an IRS employee could more easily selectively target individuals for audit. A recent investigation found that an employee assigned to a compliance project obtained the tax returns of, and initiated an examination against, a neighbor with whom the auditor was having a personal dispute.*

*MACS data discs were not always secured, potentially exposing millions of taxpayer return facsimiles to browsing, disclosure, or other integrity problems.*

*MACS data discs (CDs) could not be readily accounted for and were not always adequately secured (4 of 14 districts). Unless all discs containing electronic MACS data are accounted for properly, millions of taxpayers’ personal and financial data could be subject to improper disclosure, unauthorized access, and misuse. IRS procedures indicate that CDs should be stored in an off-site location, preferably in a vault. In one office, a former system administrator had two CDs containing taxpayer data. In another office, MACS CDs and software were stored in an unlocked cabinet within the Automated Examination Systems work area. The cabinet was accessible to all employees working in or visiting the area.*

*Controls were not established over MACS facsimile returns while they were screened for audit potential (12 of 14 districts). Unless MACS facsimile returns can be*

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identified and located throughout the audit selection process, there is an increased risk that sensitive data could be lost, stolen, or improperly disclosed. For example, MACS facsimile returns are routinely printed, screened by examiners, and either shredded or selected for audit before they are entered onto IRS' control systems, Examination Returns Control System (ERCS)/AIMS. This practice is contrary to the DIF system where returns are controlled on AIMS during the classification and selection processes.

*Audit trail files designed to detect an unauthorized access once it occurs were not always reviewed or maintained.*

*Audit trail files were not always reviewed, backed up, and/or maintained (13 of 14 districts).* Unless audit trails are retained and reviewed, allegations of unauthorized accesses cannot be investigated nor can patterns of use be evaluated to identify other integrity problems. Through discussions with staff at several sites, we determined they had not performed the required reviews. In addition, they indicated they had not received adequate training to identify inappropriate accesses and potential misuse of MACS data. In two districts, poor maintenance contributed to the irrevocable loss of audit trail data.

*Command level audit trails were not capturing system level activity because they were disabled or not working (7 of 14 districts).* Unless command level audit trails are functioning properly, security officer and system administrator actions are not recorded. As a result, taxpayer records could be copied without authorization or critical files such as audit trails that capture accesses to taxpayer records could be deleted without detection.

*MACS audit trail files did not automatically capture system queries (14 of 14 districts).* Unless audit trail files systematically record the formulas (MACS filters) used to query MACS returns, it is very difficult, if not impossible, to provide assurance to stakeholders that there has not been browsing, disclosure, or other integrity problems. For example, one district's audit trail files for a two-month period show taxpayer return data were accessed through 679 queries. However, the components or formulas could be identified and

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*Passwords for controlling access to MACS and for establishing user accountability were shared among multiple users in one district.*

*IRS needs to declare MACS a significant control weakness in the next FMFIA Assurance letter.*

*The number of MACS sites could be reduced to minimize the risk of exposing taxpayer data to unauthorized access and misuse.*

*Additional steps need to be taken to protect and secure MACS data forwarded from MDC and stored in district offices.*

evaluated only through “saved” files in 54 of the 679 queries.

*Passwords to MACS were shared among multiple users (1 of 14 districts).* When a password is shared, a critical component of computer security is missing because it is the basis of controlling access to taxpayer data and for establishing user accountability.

**We believe these control breakdowns occurred because the responsibility for maintaining controls over large amounts of sensitive data was decentralized to many employees at many sites.**

Because these problems could seriously erode the public’s confidence in IRS’ ability to protect the privacy and security of taxpayer personal and financial information, IRS management should take the following actions:

**Recommendation #1:** Declare MACS a significant control weakness under the Federal Manager’s Financial Integrity Act (FMFIA).

**Recommendation #2:** Centralize the 44 MACS sites. The risk of exposing millions of taxpayer returns to browsing, disclosure, or other integrity problems will be easier to manage with fewer MACS sites and with fewer employees having access to the system.

**Recommendation #3:** Require a separation of duties among auditors who identify MACS returns with potential tax changes, auditors who select MACS returns to be audited, and auditors who conduct the examinations. This could be accomplished by locating MACS in offices other than those that will be performing the audits.

**Recommendation #4:** Ensure that all MACS data discs forwarded from the MACS Development Center (MDC) to district offices are properly accounted for and secured. IRS officials stated that MACS program files are needed to access the data. However, with today’s technology and skill level of computer users, additional security controls are needed. We suggest encrypting the data and making the data inaccessible at a pre-determined time.

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*Audit trail files need to automatically capture taxpayer data queries.*

*The MACS handbook needs to contain examples of properly prepared MACS research requests for employees to follow.*

**Recommendation #5:** Ensure ERCS/AIMS controls are established over all printed MACS facsimiles so that the location and status of returns can be identified. Controls over MACS examinations would then be similar to those identified by DIF.

**Recommendation #6:** Ensure appropriate employees, including managers, are knowledgeable of MACS audit trail files and how the information can be used to detect an unauthorized access once it occurs.

**Recommendation #7:** Use a proven device to automatically record system level activity.

**Recommendation #8:** Change audit trail files so that they systemically record query components (MACS filters).

**Recommendation #9:** Ban the use of vague MACS research requests and provide examples of properly prepared research requests in the Internal Revenue Manual (IRM) MACS handbook for the staff to follow. At a minimum, each request should be for a specific taxpayer, select group of taxpayers, or specific project.

**Management's Response:** *The Commissioner agreed with our recommendation to report MACS as a material weakness under FMFIA. The control weaknesses surrounding MACS will be included with other management control breakdowns applicable to the selection, classification, assignment, and control of returns.*

*Other actions the Commissioner said IRS is taking that address our recommendations include:*

- *Developing new IRM material for control issues in the Planning and Special Procedures (PSP) handbook.*
- *Revising Compliance Initiative Project procedures.*
- *Working on future workload identification and delivery concepts, including alternative approaches for separating case selection and assignment practices.*

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- *Requiring the return of all MACS data disks to the MDC for storage and safekeeping.*
- *Analyzing the cost versus benefits of encrypting MACS data.*
- *Adding an indicator on MACS to show when returns are printed so that their location and status can be easily identified.*
- *Enhancing MACS to associate the Taxpayer Identification Number of the primary case with other related returns so that the appropriateness of these accesses can be easily evaluated.*
- *Providing audit trail training nationwide.*
- *Replacing the Assure Cards with the Real 32 operating system.*
- *Issuing memoranda to IRS field offices reinforcing the need to document specific data, including filter criteria, on MACS research requests.*

*The Commissioner did not agree with our recommendation to centralize MACS sites. However, he stated that the management of MACS should be centralized and is considering short-term and long-term solutions.*

Office of Audit's Comment: *Our discussions with IRS officials indicate they are considering centralizing management oversight of MACS under a National Office analyst as a short-term solution. IRS officials envision the analyst would be responsible for reviewing and approving MACS research requests.*

*We still believe MACS control breakdowns occurred because the responsibility for maintaining controls over large amounts of sensitive data is decentralized among too many employees in too many sites. However, we see the short-term solution that IRS officials are considering as a step that would provide for better separation of duties and enable IRS to easily identify misuses of MACS after they occur.*

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### **Actions Taken by Examiners and Managers During the Initiation and Closing of Non-DIF Audits Led to Improper Taxpayer Treatment**

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We reviewed 1,806 Fiscal Year 1997 non-DIF closed examinations and 577 non-examined disposals from 80 office audit groups (a total of 2,383 returns from 27 districts). We also supplemented our closed case reviews with on-site visits to 27 groups in 14 district offices. From the information in the case files and on-site visits, we identified the following areas in the initiation and closing of audits where actions taken by examiners and managers may have led to improper taxpayer treatment and/or reduced reliability of program statistics.

*Low-income taxpayers claiming an EITC were routinely requested to provide IRS with amounts spent for personal items.*

*Audit initiation letters for 3,500 audits in 2 districts contained unreasonable and intrusive requests for information.* Requests for information from low-income taxpayers claiming an Earned Income Tax Credit (EITC) contained over 80 items for the taxpayer to consider. In addition, information requested such as amounts spent on food, clothing, gifts, cosmetics, and laundry had little, if any, relevance to the issues being questioned.

*Taxpayers were not forwarded required notices in 61 percent of the audits reviewed.*

*Taxpayers were not always properly notified that an examination had been initiated (1,117 out of 1,806 audits from 27 districts).* These cases showed no evidence that taxpayers were forwarded one or more notifications required by law or procedures, such as Publication 1 (Your Rights as a Taxpayer), Notice 609 (Privacy Act Notice), and Notice 782 (Information on Tax Examinations). Internal Revenue Code §7521 indicates that IRS should provide Publication 1 to taxpayers when they are audited. The Privacy Act of 1974 also requires that IRS provide the Notice 609 to taxpayers that are selected for audit. Figure 2 shows the number of cases where we found no evidence that taxpayers were forwarded required notifications at the start of their audits.



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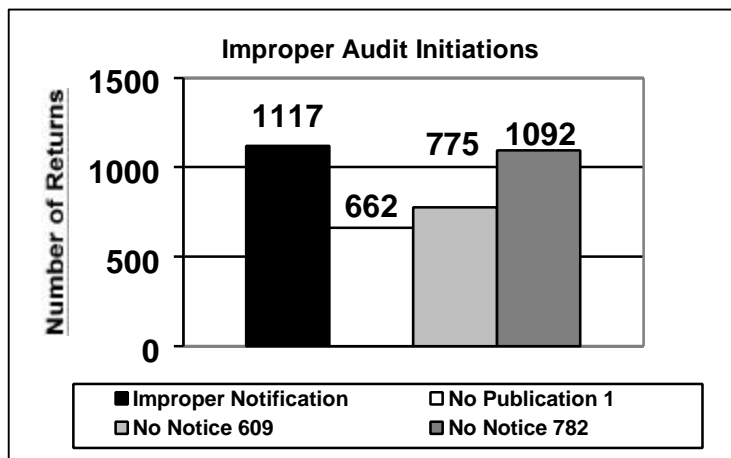


Figure 2

*Form letters were altered locally, which could add to perceptions that IRS treats taxpayers inconsistently.*

*Form letters were altered without permission from IRS' National Office. These letters contained conflicting or confusing information that could add to perceptions that the IRS treated taxpayers inconsistently (573 out of 1,806 audits from 26 districts). Instead of using the standard audit initiation letters to begin these audits, IRS field office employees initiated them with either a Notice of Proposed Adjustments (30-day letter), Collection Division Letter 964(DO), or other locally generated letter. For example, taxpayers in 1 district were only given 5 days to agree with proposed changes or request a meeting with the IRS Appeals Function before 90-day letters were issued to them. IRS procedures and publications indicate that taxpayers should have, at a minimum, 30 days to consider proposed changes.*

*Taxpayers were routinely requested to provide to examiners documents which they had previously submitted.*

*Case files showed no evidence that examiners considered using Corporate Files On-line (CFOL) before requesting taxpayers to provide copies of their tax returns (343 out of 1,410 applicable audits from 21 districts). Taxpayers were routinely requested to provide IRS with copies of their returns so examiners could determine whether the audit needed to be expanded. The issue(s) raised in many cases could have been resolved using IRS facsimile returns. Requesting*

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*Because AIMS procedures were not followed, cycle time was understated by 53,177 days for 361 audits.*

*Returns were improperly closed as "surveys" which unnecessarily engaged taxpayers with the agency.*

taxpayers to provide IRS with returns previously submitted unnecessarily imposes additional burden.

*AIMS procedures were not properly followed, which reduced the reliability of cycle time, a key program statistic for tracking the length of examinations (361 out of 1,806 audits from 26 districts).* This condition involved groups not consistently updating returns to the correct AIMS status code to show that an audit had been initiated. Because AIMS updating procedures were not followed, cycle time for 361 audits was understated by an estimated 53,177 days (147 average days per audit).

*Returns selected for audit were improperly closed as "surveys" (non-examined closures) instead of as "examined without a change" or "with an additional assessment" (211 out of 785 non-examined returns from 15 districts).* This practice reduces the reliability of program statistics, causes taxpayers to be treated inconsistently, and could lead to inadvertently violating the prohibition against repetitive audits under Internal Revenue Code §7605 if the same tax period is subsequently examined. In one case, a taxpayer agreed to, and paid a partial payment toward, a deficiency even though the return was stamped and signed by the group manager as a "survey."

Our evaluation of these concerns suggests two overriding factors contributed to the problems. Additional steps must be taken at the group level and quality control level to ensure taxpayers with returns in the audit stream are treated properly.

### **Audit groups need to be better informed about the laws and IRS procedures that govern interactions with the public.**

IRS has many procedures in place to help govern its interactions with taxpayers that should help make sure taxpayers are treated properly. Among the procedures are:

- Providing Publication 1 (Your Rights as a Taxpayer), Notice 609 (Privacy Act Notice), and

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*IRS has many procedures in place to help govern its interactions with taxpayers.*

Notice 782, (Information on Tax Examinations) when notifying taxpayers that their return will be examined.

- Requiring that public-use forms such as audit initiation letters and Notices of Proposed Changes (30-day letters) not be altered without National Office approval.
- Requiring examiners to use the CFOL system instead of taxpayer copies for information relating to prior and subsequent year returns.
- Limiting unreasonable and intrusive requests for personal expense items associated with financial status audits and economic reality examination techniques.

*Many of the problem cases involved one or two issues that were handled as correspondence audits.*

Many of the cases where laws and/or procedures were not followed involved returns with one or two issues that were handled as correspondence audits. Lower-grade examiners who may have relatively little office audit experience typically work these cases. For example, management in one district showed us a group made up exclusively of employees, including the group manager, who had recently transferred from other IRS positions and had no prior office audit experience.

IRS' office audit guidelines provide very little direction for examiners conducting correspondence audits in district offices. The IRM contains only two paragraphs indicating that correspondence audits should be examined by service center personnel and only in limited circumstances by district office examiners.

The use of relatively inexperienced examiners, when combined with a lack of IRM guidance and the other concerns raised in our case reviews, strongly suggest that IRS management needs to take the following actions.

**Recommendation #10:** Declare the control system designed to protect taxpayers during the initiating and closing of office audits as a material weakness under FMFIA.

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*IRS employees need to become more knowledgeable about procedures designed to make sure taxpayers are treated properly during audits.*

**Recommendation #11:** Take appropriate remedial action in all office audit cases opened, closed, and surveyed within the last 12 months where taxpayers were not properly informed of their rights or where audits were improperly closed as surveys.

**Recommendation #12:** Ensure examiners, including managers, are better informed and educated about IRS procedures that are designed to ensure taxpayers are treated properly during audits. These actions could include (1) issuing a memorandum to employees and group managers emphasizing existing IRS procedures for safeguarding taxpayer rights and (2) communicating procedures in future Continuing Professional Education sessions and/or training class modules.

**Recommendation #13:** Clarify the IRM to provide specific guidance for conducting correspondence audits in district office settings.

**Management's Response:** *The Commissioner agreed that control breakdowns occurred and will be reporting them as material control weaknesses under the FMFIA. In addition, he stated that IRS would:*

- *Prepare a comprehensive memorandum to the field offices that provides procedures and requirements for conducting correspondence examinations in the district environment.*
- *Provide training for managers, examiners, and PSP personnel reinforcing their responsibilities for ensuring that all taxpayer rights are protected. Appropriate procedures for correspondence examinations will be emphasized as part of this training.*
- *Include comprehensive requirements for protecting taxpayer rights and for documenting the actions taken in the new IRM Handbook "Examination of Returns."*
- *Emphasize protection of taxpayer rights and the use of appropriate correspondence procedures in all future peer reviews.*

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- *Develop an action plan for taking remedial action in cases where taxpayers were not treated properly.*

### **Quality controls could be expanded.**

Among other responsibilities, the Quality Measurement Staff, under the Office of Compliance Specialization, evaluates samples of closed examinations to identify technical and procedural problems, and to advise management when corrective actions are needed. The Examination Quality Measurement Systems (EQMS) sets forth nine standards, and additional key elements within each standard, that are used by the Quality Measurement Staff to make their closed case evaluations.

*The nine standards and their elements provide very little, if any, guidance or feedback on how well IRS' procedures governing taxpayer treatment are followed during audits.*

The standards and their key elements provide guidance to auditors and measures for management on how well (1) time is managed, (2) large and unusual items are checked, (3) probes for unreported income are performed, and (4) workpapers are prepared. The nine standards and their elements provide very little, if any, guidance to auditors or feedback to managers on how well IRS' procedures governing taxpayer treatment are followed during audits.

To gauge taxpayer perceptions about the audit process, EQMS sends a questionnaire to taxpayers who were recently examined. However, IRS officials told us that only about 50 percent of the taxpayers responded, which potentially reduces the reliability of the results. While the questionnaire has value, IRS would get a more complete picture of how taxpayers were treated during audits by evaluating the issue through EQMS reviews.

*IRS needs a system to provide feedback on the appropriateness of "survey" decisions.*

Another concern related to quality controls is that IRS does not have a system in place to evaluate the appropriateness of or trends in non-examined disposals. To ensure non-examined disposals, such as "surveys," are proper, IRS relies on the group manager. However, we question the effectiveness of this control after finding instances where managers approved non-examined

## The Internal Revenue Service Needs to Improve Treatment of Taxpayers During Office Audits

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closures after taxpayers were contacted and records obtained.

A system such as EQMS needs to be used to determine whether non-examined disposals are appropriate. Besides determining if the disposal was proper, the system could also be used to identify trends for improving return ordering and selection.

**Recommendation #14:** Expand EQMS standards and/or key elements to address the proper treatment of taxpayers, including whether managers were involved in unagreed cases.

**Recommendation #15:** Implement a system to determine whether non-examined disposals ("surveys") are appropriate and to aid in identifying trends for improving return ordering and selection.

**Management's Response:** *The Commissioner agreed with our recommendation of having EQMS reviews evaluate how taxpayers are treated during audits and whether managers are involved in resolving disagreements. He included the revised EQMS standards as an attachment to his response.*

*In addition, the Commissioner agreed to implement a system to review "surveys." IRS field offices are directed to review a statistical sample of no less than five percent of the returns surveyed. The purpose of the review is to reduce incorrect practices and improve the screening/classification process.*

## Conclusion

Due to the control breakdowns and the inappropriate practices identified during this audit, the IRS risks:

- (1) Losing the public's confidence in its ability to protect the privacy and security of taxpayers' personal and financial information.
- (2) Contributing to taxpayers' perceptions that they are not treated fairly by the IRS.

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By implementing the recommendations presented in this report, IRS management can reduce taxpayer burden and significantly reduce the risks that taxpayer rights will be abused.

### **Detailed Objectives, Scope, and Methodology**

We attempted to identify, through closed case reviews and on-site visits, instances where taxpayers were, or could perceive they were, harmed when an Internal Revenue Service (IRS) employee (1) violated a law or regulation, or (2) did not follow IRS procedures that govern its interactions with taxpayers. Initially we selected, for our closed case review and on-site visits, the 20 tax auditor groups in each region (80 groups in 27 districts) that generated the most dollars per hour in Fiscal Year (FY) 1997.

For our closed case review, we judgmentally sampled from each group 40 closures that included agreed assessments, non-examined disposals, and assessments that defaulted. Although we reviewed cases from 27 of 33 district offices, the actual number of cases reviewed varied from group to group because some cases could not be obtained within our scheduled time frame for completion and because of the groups' case closure patterns. We decided not to pursue on-site testing in 13 of 27 districts initially selected after assessing the extent of control breakdowns in the first 14 districts visited. Test results from the 14 districts clearly indicate that taxpayer treatment is a concern nationwide. Table 1 on the following page details the districts included in the review. Overall, we:

- Evaluated a sample of 702 agreed examinations closed by 27 district offices in FY 1997.
- Evaluated a sample of 490 no-show/no-response examinations closed by 25 district offices in FY 1997.
- Evaluated a sample of 624 defaulted examinations closed by 25 district offices in FY 1997.
- Evaluated a sample of 785 returns closed as non-examined disposals by 24 district offices in FY 1997.
- Performed on-site visits to 27 office audit groups in 14 district offices to assess current office audit practices.
- Performed on-site visits to 14 district offices and evaluated how well controls protected access to tax return information on the Midwest Automated Compliance System.



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**Table I - IRS' District Offices Reviewed**

Districts	On-site Visits to MACS Units	On-Site Visits to Tax Group(s)	Closed Case Review
<b>Mid-States Region</b>			
Illinois	X	X	X
Midwest			X
North Central			X
Kansas – Missouri			
Arkansas-Oklahoma		X	X
South Texas			X
North Texas	X	X	X
Houston	X	X	X
<b>Northeast Region</b>			
New England	X	X	X
Conn – Rhode Island			X
Brooklyn			
Manhattan	X	X	X
Upstate New York			
New Jersey	X	X	X
Pennsylvania			X
Ohio			X
Michigan			X
<b>Southeast Region</b>			
Indiana			X
Delaware – Maryland			X
Virginia – West Virginia	X	X	X
North – South Carolina	X	X	X
Georgia			X
North Florida			X
Kentucky – Tennessee			
South Florida			X
Gulf Coast	X	X	X
<b>Western Region</b>			
Southern California	X	X	X
Central California			
Rocky Mountain	X		X
Southwest	X	X	X
Pacific – Northwest			
Northern California	X	X	X
Los Angeles	X	X	X

**Major Contributors to This Report**

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District Director (Virginia-West Virginia)  
District Director (North-South Carolina)  
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**Appendix IV**

**Management's Response to the Draft Report**



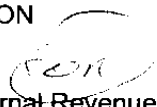
COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

February 12, 1999



MEMORANDUM FOR ACTING TREASURY INSPECTOR GENERAL FOR  
TAX ADMINISTRATION

FROM: Charles O. Rossotti   
Commissioner of Internal Revenue

SUBJECT: Response to Draft Internal Audit Report--Review of Taxpayer  
Treatment During the Selection, Initiation, and Closing of Office  
Audits

Thank you for your review of taxpayer treatment during the selection, initiation, and closing of office audits. Your draft report unfortunately identified a number of weaknesses which are in conflict with the Internal Revenue Service's (IRS) ongoing efforts to carry out its new mission: "To provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." In this regard, the IRS has initiated corrective actions which are consistent with most of your recommendations.

Attachment 1 of this letter contains our responses to the specific recommendations. Attachment 2 contains the revised elements and standards. Attachment 3 is a copy of the memorandum of instructions requiring the review of surveyed returns based on a statistical sample representing no less than 5 percent of surveyed returns.

If you have any issues or questions that you would like to discuss, please call me, or have a member of your staff call Thomas W. Wilson, Jr., Assistant Commissioner (Examination) at (202) 622-4400.

Attachments (3)

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Attachment 1

**Recommendation #1:** Declare the Midwest Automated compliance System (MACS) a significant control weakness under the Federal Managers' Financial Integrity Act (FMFIA).

**ASSESSMENTS OF CAUSE(S):**

Weaknesses identified were caused by failure to exercise established management internal controls that are applicable to the selection, classification, assignment, and control of returns, which are managed by Examination. This includes returns obtained through MACS. In this regard, the weaknesses identified by Internal Audit were not a result of system weaknesses in MACS, but rather as a result of management control breakdowns, which are in the process of being corrected.

**CORRECTIVE ACTIONS:**

To address these management control weaknesses, we will be reporting it as a material weakness under the FMFIA. Specific actions being taken include:

- 1.1 - New Internal Revenue Manual (IRM) material specific to control issues has been developed for the PSP Handbook.
- 1.2 - Comprehensive Compliance Initiative Project (CIP) procedures, applicable to all Compliance functions, were developed and issued via Acting Chief Compliance Officer memorandum dated September 4, 1997. They are currently being revised to incorporate feedback from the field and to conform with the new IRM format requirements.
- 1.3 - Working with representatives of the Design Teams to gain insight on their concepts of workload identification and delivery for the future.
- 1.4 - Working with responsible Examination personnel to review alternative approaches to separating case selection and case assignment duties. Consideration will be given to the role of the four operating divisions at that time.

**IMPLEMENTATION DATE:**

- 1.1 - Finalize and incorporate new IRM Chapter, June 1999
- 1.2 - Incorporate CIP Handbook into IRM, June 1999
- 1.3 - Completed
- 1.4.1 - Completed
- 1.4.2 - Recommendations to Assistant Commissioner (Examination), March 1999

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

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**Recommendation #2:** With changes underway to reorganize the IRS into four operating divisions, the 44 MACS sites should be centralized. We believe that the risk of exposing millions of taxpayer returns to browsing, disclosure, or other integrity problems is easier to manage with fewer MACS sites and with fewer employees having access to the system.

**ASSESSMENTS OF CAUSE(S):**

Although we do not agree to the recommendation to centralize the MACS site, we believe that the management of MACS should be centralized, and we are currently considering short-term and long-term solutions. Centralizing the MACS sites would not eliminate the potential risk of exposing taxpayer data to potential browsing, disclosure, or other integrity problems. To remove MACS from the districts would pose the threat that districts would acquire the data contained in MACS from another source and use it in an unsecured, uncontrolled environment as was done prior to the implementation of MACS. There are very few people with access to MACS. The same number of people, or more, would need access to MACS even if centralized. These individuals would be using the data in the same way that district employees are using the data with the same controls.

MACS is used by the districts for many purposes only one of which is surfacing potential noncompliant returns for audit. In addition, removing MACS from the districts would be in direct contrast to Policy Statement P-1-40, entitled "Studies, tests and research projects to improve operations and decision-making are essential throughout the Service." It is also premature to speculate on the roles and responsibilities of the four operating divisions.

**CORRECTIVE ACTIONS:**

Same as in Recommendation #1.

**IMPLEMENTATION DATE:**

Same as in Recommendation #1.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #3:** Require a separation of duties between auditors who identify MACS returns with potential tax changes, auditors who select MACS returns to be audited, and auditors who conduct the examinations. This could be accomplished by locating MACS in offices other than will be performing audits.

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**ASSESSMENTS OF CAUSE(S):**

As outlined in Recommendation #2, Examination personnel are working to evaluate approaches to separating case selection and case assignment duties for all Examination workload. We expect that by expanding our area of consideration beyond one fractional portion of the process such as MACS, we will be more successful at developing an effective, comprehensive solution.

**CORRECTIVE ACTIONS:**

Same as in Recommendation #1.

**IMPLEMENTATION DATE:**

Same as in Recommendation #1.

**RESPONSIBLE OFFICIAL:**

Same as in Recommendation #1.

**Recommendation #4:** Make sure that all MACS data discs forwarded from the Midwest Development Center (MDC) to district offices are properly accounted for and secured. IRS officials stated that MACS program files are needed to access the data. However, we believe that with today's technology and skill level of computer users, additional security controls are needed. We suggest encrypting the data and making the data inaccessible at a predetermined time.

**ASSESSMENTS OF CAUSE(S):**

The software and the data forwarded from the MACS Development Center (MDC) to district offices are sent to two separate people in two separate functions. The system has a security certification and the issues of disk security have been assessed twice. The receipt and control over the data disks were, and is, the responsibility of the local Information Systems' data or systems control point per the written procedures.

Assuming one could obtain a data disk, the only way the MACS/RTF data can be read is if one were to have both the MACS software and the compression program and he/she would then have to install them on a PC with a modified REAL 32 operating system.

Comprehensive procedures are in place for the secure handling and storage of MACS data disks, even though the data is only readable on a MACS machine

**CORRECTIVE ACTIONS:**

In a memo dated August 6, 1998, we established an additional requirement that all MACS data disks must be returned to the MACS Development Center (MDC) for storage and safekeeping after the data is loaded onto the MACS machine in the district.

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Failure to return the data disks to MDC will jeopardize the continued receipt of data by that district. The process will be monitored closely by the appropriate branch chief in each site and the MDC Staff. Whereas, we do not see a need to add encryption to the safeguards already in place; we will work with the Office of Systems Standards and evaluation to perform an analysis.

**IMPLEMENTATION DATE:**

- 4.1 - Completed an additional requirement for disk management, August 1998.
- 4.2 - Analyze the cost versus benefits of encryption, August 1999.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #5:** Take action to establish ERCS/AIMS controls over all printed MACS facsimiles so that the location and status of returns can be identified. Controls over MACS examinations would then be similar to those identified by DIF.

**ASSESSMENTS OF CAUSE(S):**

AIMS controls are not required for tax return information like a MACS until it is determined that they will be audited. All MACS prints are not established on AIMS because they are not returns; they contain tax return information. MACS prints can be used in lieu of an original return and when that determination is made, MACS prints are then treated as return facsimiles. At that point, AIMS IRM 48(13)1.220 states: "As soon as it has been determined that a return will be examined, Forms 5345, 5347, or 5354 must be prepared to establish the return on AIMS." Additionally, to control all MACS prints on AIMS/ERCS would seriously overburden both the system(s) and the employees responsible for the actions. Also, adherence to the Form 3210, Document Transmittal, procedures is also being monitored through the Peer Review Process.

The procedures for MACS prints are in accordance with "other source" workload and with established IRM requirements. We have taken steps to enhance the MACS audit trail and MACS print process.

**CORRECTIVE ACTIONS:**

- 5.1 - When a MACS print is generated, an indicator will become part of the audit trail.
- 5.2 - Once generated, the print can be identified as a return facsimile or for information only (for case building purposes).
- 5.3 - The MACS software will be enhanced to allow for the user to enter the Taxpayer Identification Number (TIN) of the primary case when researching related entities on MACS. Therefore, the related TINs will be associated on the audit trail.



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**IMPLEMENTATION DATE:**

5.1 - Completed October 1998.

5.2 - MACS software release, February 1999

5.3 - MACS software release, February 1999

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #6:** Make sure appropriate employees, including managers, are knowledgeable of MACS audit trail files and how the information can be used to detect an unauthorized access once it occurs.

**ASSESSMENTS OF CAUSE(S):**

A weakness in this area was identified in 1997. In this regard, most security officers did not know how to review audit trails because no training or instruction was available. Examination was assigned responsibility for reviewing the audit trails in 1998. Subsequently, audit trail training was developed and has been taught nationwide. Procedures were added to the MACS Handbook that audit trails must be backed up weekly and reviewed monthly.

**CORRECTIVE ACTIONS:**

Action taken by Examination to develop and implement audit trail training addresses this recommendation.

**IMPLEMENTATION DATE:**

Completed December 6, 1998.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #7:** Use a proven device to automatically record system level activity.

**ASSESSMENTS OF CAUSE(S):**

Multiuser DOS was the original operating system and an Assure Card was installed in each machine to ensure security. Some users found that the Assure card caused systems failures or significantly decreased the speed of the system. As a result, they disengaged the Assure Card not realizing that one of the audit trails was then no longer recorded.

**CORRECTIVE ACTIONS:**

Replacing the current Real 32 operating system and software improvements to

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enhance systems security were in process prior to the internal audit. Installation of the system began in 1997 and was completed in November 1998.

**IMPLEMENTATION DATE:**

Completed November 1, 1998.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #8:** Change audit trail files so that they systemically record query components (MACS filters).

**ASSESSMENTS OF CAUSE(S):**

We believe that this concern on tracing queries is being addressed. All appropriate query components are documented on the MACS research requests and are tied to the control numbers on the audit trails.

While it is true that MACS does not capture the filter criteria on the systemic audit trail, the audit trail does capture the MACS control number. The MACS control number can be traced to the MACS research request, and the MACS research request contains the filter criteria. Management controls for MACS require that certain query components, such as filters, be documented as part of the paper audit trail. Adding the filter criteria to the electronic audit trail will add little value and will cause the audit trails to become unnecessarily voluminous.

**CORRECTIVE ACTIONS:**

A memorandum will be issued reinforcing the need to record the filter criteria on the MACS research request or similar paper documentation. We will also reinforce the need to document all changes made to the filters.

**IMPLEMENTATION DATE:**

Memorandum to be issued by March 1999.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #9:** Ban the use of vague MACS research requests and provide examples of properly prepared research requests in the MACS handbook (IRM) for the staff to follow. At a minimum, each request should be for a specific taxpayer, select group of taxpayers, or a specific project.

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### ASSESSMENTS OF CAUSE(S):

Although procedures addressing this recommendation are already in place, it appears that some district personnel have not adhered to these procedures.

The MACS Handbook (IRM) discusses when generic research requests are appropriate. Generic research requests are appropriate in some instances, such as for case building for returns already on AIMS, for profiling the district's filing population, etc. In other circumstances, such as identifying potentially noncompliant individuals within a market segment, the research request should be sufficiently specific to ensure that no taxpayers are illegally targeted. Examples of specificity for market segment use were added to the MACS Handbook prior to March 1998.

### CORRECTIVE ACTIONS:

The corrective actions under #1 above apply.

9.1 - A memorandum will be issued reinforcing the need to be specific when preparing MACS research requests and when generic research requests are appropriate as per the MACS IRM Handbook.

### IMPLEMENTATION DATE:

Memorandum to be issued by March 1999.

### RESPONSIBLE OFFICIAL:

Assistant Commissioner (Examination)

**Recommendation #10:** Declare the control system designed to protect taxpayers during the initiating and closing of office audits as a material weakness under FMFIA.

### ASSESSMENTS OF CAUSE(S):

Based on the information contained in the draft report, correspondence examination activity appears to be the primary source of the control breakdowns related to initiating and closing examinations in office audit. However, it would be helpful to have a meeting with Internal Audit to verify the scope of the control breakdowns.

### CORRECTIVE ACTIONS:

We agree that several control breakdowns have occurred. Many procedures have been implemented immediately before, during, and subsequent to this Internal Audit review. The nationwide implementation of the Examination Internal Controls workshop, the renewed focus and clarification of Policy Statement P-1-20, the de-emphasis on numerical goals and comparisons, the Peer Review Process, the implementation of a program to stop unauthorized access (UNAX), and the proposals surrounding the RRA of 1998, especially RRA Section 1203, have all contributed to a greater awareness of the importance of protecting taxpayer rights. Also, as mentioned under

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Recommendation #1, we have already begun the process of revisiting workload selection and assignment processes within Examination and will consider all sources of work as part of that process. In the interim, we will take the following actions to specifically address correspondence audits at the district level:

- 10.1 - Prepare a comprehensive memorandum to the regions providing procedures and requirements for conducting correspondence examinations in the district environment.
- 10.2 - Provide training for managers, examiners, and PSP personnel reinforcing their responsibilities for ensuring that all taxpayer rights are protected. Appropriate procedures for correspondence examinations will be emphasized as part of this training.
- 10.3 - Include comprehensive requirements for protecting taxpayer rights and for documenting the actions taken in the new IRM Handbook "Examination of Returns" (4.2)
- 10.4 - Emphasize protection of taxpayer rights and use of appropriate correspondence procedures in all future Peer Reviews.

**IMPLEMENTATION DATE:**

- 10.1 - March 31, 1999 - Proposed Date - Memorandum
- 10.2 - September 30, 1999 - Proposed Date - Completion of training
- 10.3 - March 31, 1999 - Proposed Date - IRM 4.2 Published
- 10.4 - Ongoing - Peer Reviews

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #11:** Take appropriate remedial action in all office audit cases opened, closed, and surveyed within the last 12 months where the taxpayer was not appropriately informed of their *[sic]* rights or where audits were improperly closed as surveys.

**ASSESSMENTS OF CAUSE(S):**

See #10 above. In addition, the primary impetus behind this recommendation appears to be that the case files were not fully documented in detailing actions taken or information mailed to taxpayers.

**CORRECTIVE ACTIONS:**

See #10 above. In addition, the IRS will assess the level of effort to document this problem and will develop an action plan to take remedial actions.

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**IMPLEMENTATION DATE:**

See #10 above.

11.1 - Remedial action on surveyed cases, March 1999.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #12:** Take actions to make sure examiners, including managers, are better informed and educated about IRS procedures that are designed to ensure taxpayers are treated properly during audits.

**ASSESSMENTS OF CAUSE(S):**

See #10 above.

**CORRECTIVE ACTIONS:**

See #10 above.

**IMPLEMENTATION DATE:**

See #10 above.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #13:** Clarifying the IRM to provide specific guidance for conducting correspondence audits in district office settings.

**ASSESSMENTS OF CAUSE(S):**

See #10 above.

**CORRECTIVE ACTIONS:**

See #10 above.

13.1 - Revise the Group Manager's Handbook to include guidance for conducting correspondence audits in district office settings.

**IMPLEMENTATION DATE:**

See #10 above.

13.1 - March 31, 1999 - Proposed Date - Revised IRM published.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

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**Recommendation #14:** Expand the EQMS standards and/or key elements to address the proper treatment of taxpayers including whether managers were involved in unagreed cases.

**ASSESSMENTS OF CAUSE(S):**

See #10 above.

**CORRECTIVE ACTIONS:**

The latest revision of EQMS, implemented November 2, 1998, included significant changes to the structure of the Auditing Standards. The revised Auditing Standards are as follows: (1) Audit Planning; (2) Audit Scope; (3) Income Probes/Determination; (4) Audit Techniques; (5) Work papers/Reports; (6) Application of Law/Tax Determination; (7) Timeliness; and (8) Customer Service/Professionalism.

There are 22 questions within the first 7 standards that address the proper treatment of taxpayers. Questions include consideration of collectible issues, use of internal sources of information, proper determination of the scope and depth of issue development, intrusiveness of information requests, and the timeliness of the exam (time applied and time span of audit).

Standard 8 specifically addresses concepts of "One Stop Service," Communication and Taxpayer Burden, and Taxpayer Rights. There are 11 factors/questions addressed in the 3 elements of this standard. A question regarding managerial involvement (which identifies whether a manager is involved in unagreed cases) is included in the Communication and Taxpayer Rights category. (Attachment 2 contains the revised elements and standards.)

**IMPLEMENTATION DATE:**

Completed November 2, 1998.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

**Recommendation #15:** Implement a system to determine whether nonexamined disposals (surveys) are appropriate and to aid in identifying trends for improving return ordering and selection processes.

**ASSESSMENTS OF CAUSE(S):**

See #10 and #11 above.

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**CORRECTIVE ACTIONS:**

- 15.1 - Instructions in memorandum form were provided to the regions requiring the review of surveyed returns based on a statistical sample representing no less than 5 percent of surveyed returns. The purpose of this review is to (1) reduce incorrect survey practices, and (2) analyze surveyed returns to improve the screening/classification processes, with the goal of preventing returns without audit potential from entering the examination stream. (Attachment 3 is a copy of the memorandum.)
- 15.2 - The revised PSP IRM will include the same requirement for review of surveys.

**IMPLEMENTATION DATE:**

- 15.1 - Completed August 13, 1998.  
15.2 - Proposed Date - June 1999.

**RESPONSIBLE OFFICIAL:**

Assistant Commissioner (Examination)

CONCUR: \_\_\_\_\_

DO NOT CONCUR: \_\_\_\_\_

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

# The Internal Revenue Service Needs to Improve Treatment of Taxpayers During Office Audits

Attachment 2

## EQMS Quality Standards As Revised, for Reference.....

1. Audit Planning
  - A. Prior to taxpayer contact:
    1. If collectibility considered?
    2. Were internal information sources queried?
    3. Was preplan time commensurate with complexity of return?
  - B. Taxpayer Contact:
    - \* 1. Were Power of Attorney requirements followed?
    2. Were preplanned issues shared?
    3. Was the initial Information and Document Request clear/concise, and appropriate?
    4. Was the availability of books and records determined?

S1. Overall, in the reviewer's judgment, was the examination appropriately planned?
2. Audit Scope
  - A. Large, Unusual and Questionable (LUQ) Items:
    - #\* 1. Were LUQ income, deduction, balance sheet and/or credit items considered?
    2. Were *only* material issues considered?
    3. Was the scope appropriately expanded/contracted?
  - \*B. Multi-Year/Related Returns: Were prior year, subsequent and related returns included in the examination (including adjustments in favor of the taxpayer), where warranted?
  - C. Required Filing Checks: Were all filing/compliance requirements considered?
  - D. Compliance impact: If other taxpayers were affected, were appropriate actions taken?

S2. Overall, in the reviewer's judgment, was the examination's scope appropriate?
3. Income Probes/Determination
  - A. Were books and records considered?
  - #\* B. Were appropriate techniques used to determine income?
  - \* C. Were techniques applied correctly?

S3. Overall, in the reviewer's judgment, was income properly determined?
4. Audit Techniques
  - A. Were adequate interviews conducted?
  - B. Was only necessary information requested?
  - C. Were follow-up IDRS clear and concise?
  - D. Were necessary follow-ups made?
  - #\*E. Were unidentified issues properly developed? (Please refer to Standard 3 for income-related issues)
  - \*F. Were indications of fraud properly pursued and developed?

S4. Overall, in the reviewer's judgment, were proper and adequate examination techniques used?
5. Workpapers/Reports
  - A. Were workpapers legible/organized?
  - B. Was the activity records adequately documented?
  - \*C. Did workpapers/reports adequately document the audit trail, techniques and conclusions?
  - D. Was the report tied/referenced to the workpapers?
  - \*E. Were the Examiner's computations correct?
  - F. Did the Examiner use RGS/EOAD?

S5. Overall, in the reviewer's judgment, do the examination reports and workpapers document the audit sufficiently to support the conclusions reached?



## The Internal Revenue Service Needs to Improve Treatment of Taxpayers During Office Audits

2	<p>6. Application of Law/Tax Determination</p> <p>A. Was appropriate research conducted?</p> <p>#*B. Was the law correctly applied?</p> <p>C. Were penalties considered and applied as warranted?</p> <p>S6. Overall, in the reviewer's judgment, did the examiner apply the appropriate law to the case?</p> <p>7. Timeliness</p> <p>A. Was the examination started (or reassigned) within a reasonable timeframe?</p> <p>B. Were actions taken timely?</p> <p>*C. Was time spent on the examination commensurate with the complexity of the issues?</p> <p>*D. Was the time span reasonable?</p> <p>E. Did the examiner evaluate taxpayer information timely?</p> <p>S7. Overall, in the reviewer's judgment, was the examination conducted in a timely and efficient manner?</p> <p>8. Customer Relations/Professionalism</p> <p>A. One Stop Service</p> <ol style="list-style-type: none"> <li>1. Were all taxpayer concerns with the IRS addressed?</li> <li>2. Was partial agreement considered?</li> <li>* 3. Was payment solicited (full, part, or installment agreement)?</li> </ol> <p>B. Communications and Taxpayer Burden</p> <ol style="list-style-type: none"> <li>* 1. Were documented interactions and correspondence with the taxpayer/representative courteous and professional?</li> <li>2. Were taxpayers'/representatives' issues addressed?</li> <li>3. Were findings discussed with the taxpayer/representative?</li> <li>4. Was the taxpayer/representative kept apprised of the status of the case throughout the examination?</li> <li>5. Were the taxpayers'/rep's scheduling/time needs adequately considered?</li> <li>6. Was the level of managerial involvement appropriate?</li> </ol> <p>C. Taxpayer Rights</p> <ol style="list-style-type: none"> <li>#*1. Was the taxpayer/representative advised of all rights?</li> <li>#*2. Were the taxpayer's rights to privacy appropriately observed and was taxpayer confidentiality protected?</li> <li>3. 3<sup>rd</sup> Party Contacts Notification Procedures followed?</li> </ol>	<p>9. Critical Quality Elements</p> <p>Did the Examination receive a rating of "Yes" on all six critical quality elements?</p> <p>(Critical Quality Components are those marked with the pound sign (#) )</p> <p>* <u>Key</u> Quality Element: If the reviewer answers this question with a "No," the case receives no credit for the Quality Standard.</p> <p># <u>Critical</u> Quality Element: If the reviewer answers this question with a "No," the case receives no credit for Quality Standard Nine.</p>
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Attachment 3



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

AUG 13 1998

MEMORANDUM FOR REGIONAL CHIEF COMPLIANCE OFFICERS

FROM:

*Andre' L. Re*  
Andre' L. Re  
National Director  
Compliance Specialization OP:EX:CS

SUBJECT:

Review of Surveyed Cases

As we try to maximize the use of our resources in the Examination Division by examining those returns with the most potential for change, we need to refocus attention on the quality of the returns in the examination stream.

In the past, the manual required a sample review be conducted of all returns (except specialty returns) surveyed from the district (Status 10 or 12 with Disposal Codes 31 or 32). Surveyed DIF source work was to be referred to the Chief PSP for inventory analysis and to determine impact on future classification. The review is to determine whether the correct decision to survey the return was made.

The purpose of this memorandum is to restate the requirement to sample review the surveyed returns referenced above. A statistical sample representing no less than five percent is required effective the date of this memorandum. An individual decision can be made as to where/how the review is conducted. Any returns surveyed incorrectly should be returned to the group manager or branch chief as appropriate. Management should monitor the volume of the surveys and take the necessary steps to reduce incorrect surveys and/or the number of returns without audit potential from entering the examination stream. The IRM is being updated to reflect this requirement.

If you need additional information, please contact Bill Healey of my staff at (202) 401-4469.